SMBC Capital Markets, Inc.

fxPoetry

June 29, 2022

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Something Drastic

While summer in Spain is fantastic
For Madame Lagarde something drastic
Has just been released
Inflation's not ceased
With prices there far too elastic

Literally every day now, policymakers, and markets, are being disabused of the notion that inflation has peaked. No matter how many times it is repeated, it is simply not the case. The latest example comes from sunny Spain, where CPI in June rose 10.2%, far higher than May's 8.7% rise and far higher than expectations of 8.8%. Prior to this release, the narrative had been that the 9.8% print in March signaled the top and that things would be under control going forward. Alas for the good people of Spain, that is not the case. Arguably, one of the worrying things about this is that oil prices (+0.5% today) were lower through most of the month, although they are basically back to where we were at the beginning of June as of today.

Today is also the final day of the ECB's big summer gabfest in Sintra, Portugal and we are looking forward to hearing from Madame Lagarde, Chairman Powell and BOE Governor Bailey later this morning. At this stage, all eyes will be on Lagarde as she tries to continue to thread the needle of explaining what the ECB will do to prevent 'fragmentation' while tightening monetary policy. While right now, the market seems willing to accept they have some new idea, I fear that skepticism is in order. In addition, given the high inflation prints we have seen recently, there are an increasing number of ECB members now calling for a 50bp rate hike at the July meeting there although Lagarde has remained steadfast in her 25bp view. That meeting, still 3 weeks away, could be very interesting if the data continues to show weaker growth and rising prices. And what of the euro? It remains caught between and betwixt the policy differences between the two key central banks. For now, as per below, there is no indication that the Fed is backing off from its uber hawkish stance so lower still seems the path of least resistance.

Said Mester, it's just the beginning
Of rate hikes, perhaps the first inning
As well, she explained
That naught would be gained
If we keep up our money prin'ing

Speaking of the Fed and Sintra and FOMC policy, Cleveland Fed president Loretta Mester has been especially loquacious lately, explaining the Fed is "*just at the beginning of raising rates*." In fact, she went on to say that Fed funds should end the year between 3.0% and 3.5% and climb "*a little bit above 4% next year.*" I can't tell whether she is simply upset that the punditry has declared St Louis Fed president James Bullard as the most hawkish, a title she held for the past 5 years, or she is truly ready to continue tightening monetary policy regardless of the fact that the US economic situation is clearly deteriorating rapidly. Over the course of the past several weeks, virtually every US data point has not only disappointed relative to expectations but has continued its recent declining trend. Some highlights were Michigan Sentiment at 50.0, a historic low; Consumer Confidence; every regional Fed Manufacturing survey diving into negative territory and Housing stats falling sharply. All this has been combined with rising Initial Claims data and continued high price growth. Frankly, being a member of the FOMC seems like a pretty uncomfortable job these days. But remember, sympathy is scarce given the current situation is a direct result of their previous actions.

As New York walks in the door, digesting the ongoing comments from ECBers is this morning's task and net, it appears that risk appetite has been lost in the wake of all the talk of higher interest rates. Those higher rates led to significant weakness in equity markets in the US yesterday which seemed to lead to the Asian selloff (Nikkei -0.9%, Hang Seng -1.9%, Shanghai -1.4%) and Europe's continuation this morning (DAX -1.9%, CAC -1.3%, FTSE 100 -0.6%) and if you were curious, Spain's IBEX (-1.8%). As to US futures, at this hour they are very slightly softer well ahead of the opening.

Bond markets, which have not been consistently demonstrating haven characteristics at all lately, are doing so this morning with yields lower (Treasuries -1.0bps, Bunds -2.6bps, OATs -3.0bps, Gilts -0.9bps) and Italian BTPs (-8.2bps) are really benefitting as anticipation grows Madame Lagarde has something tricky up her sleeve. Overnight saw JGB yields back away from the 0.25% YCC cap and bonds throughout Asia bid up with yields declining. It is quite easy to believe that bond markets worldwide are anticipating much slower growth in the not too distant future.

Turning to the commodity markets, oil continues to rebound (WTI +1.0% now) as the combination of potentially increased demand from Chinese covid policy relaxations and the clear reduction in supply (as an aside, Libya and Ecuador have both seen their production figures plummet to add to global woes) means the structural supply shortages are not going to disappear. These prices have further to move. NatGas (+3.7% in the US, +6.6% in Europe) will continue to rise as well based on supply constraints. Gold (+0.3%) is edging higher but still going nowhere, copper (+0.5%) is surprisingly higher given the weaker economic data and aluminum (-0.5%) is fading again.

Finally, the dollar is mixed this morning, with the G10 seeing both gainers and losers and a similar situation in the EMG space. CHF (+0.75%) is by far the biggest gainer as the EURCHF cross breaks parity this morning and traders show they believe the SNB is going to defend the currency in order to fight inflation there. Remember, the SNB's target is between 0% and 2% and the latest reading was 2.9%. They raised their base rate by 50bps in a surprise move last week and now there is talk of them shrinking their balance sheet (which by the way is mostly composed of US equities like Apple, Google and Microsoft) in order to be able to support the currency and prevent price pressures from increasing. NOK (+0.35%) is the next best performer on the back of oil's continuing rebound and then the rest of the bloc is +/-0.2% or less, just waiting for the next big story.

In the emerging markets, KRW (-1.2%) was the worst performer overnight after Consumer Confidence numbers printed far lower than expected and the KOSPI (-1.8%) fell and saw international investor selling. PHP (-0.6%) is next in line as the general risk-off tone led to selling of most Asian currencies. On the flip side, HUF (+0.6%) is the big winner after yesterday's surprising 185bp rate hike demonstrating the NBH is not willing to allow inflation to continue to rise unchecked.

On the data front, this morning brings the third look at Q1 GDP (exp -1.5%) and some statistics that come with it, but tomorrow's Personal Income and Spending data as well as the PCE data are of far more interest to the market I believe.

At this point, all eyes are on Chairman Powell at 9:00am to see what he has to say alongside his counterparts at the BOE and ECB. Until we see the Fed stop talking about inflation and start mentioning growth, I see no reason to abandon the dollar higher view.

Good luck and stay safe
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